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To: Workforce Services and Community and Economic Development Interim Committee

From: Utah Department of Workforce Services, Unemployment Insurance Division
Bill Starks, Unemployment Insurance Director

Subject: 2006 Master Study List #179, Limiting Unemployment Insurance Tax Rate Increases

A request was filed “to study options to limit the amount of an employer’s Unemployment Insurance Tax rate increase and estimating the potential impact on the Unemployment Insurance Trust Fund.” The following will provide a summary on how Unemployment Insurance (UI) taxes are currently calculated, a brief background on what stimulated this study item, and two options that have been studied by the department.

UI Tax Rate Calculations and Explanations: Utah’s unemployment insurance (UI) tax rates are somewhat similar to automobile insurance rates. Drivers that have higher risk factors (accident claims and tickets) typically will have higher insurance rates than safe drivers. Similarly, employers that have higher UI benefit charges (paid to former employees), typically have higher UI tax rates than employers who maintain stable workforces. Initially all new employers are given an average rate for their industry, once they have a fiscal year of their own UI “experience” they are qualified to be assigned a rate based on their own experience. An experienced rated employer’s overall tax rate is based on a statutory formula that factors in several components to insure the solvency of the UI Trust Fund and to equitably adjust tax rates on employers that are responsible for generating these costs.

$$\frac{\text{Benefit Costs}}{\text{Taxable Wages}} \times \text{Reserve Factor} + \text{Social Rate} = \text{Overall Rate}$$

- Benefit Costs: Unemployment benefits paid to former employees that are charged to the employers account for the previous four fiscal years ending June 30th.
- Taxable Wages: Total taxable wages reported by the employer for the previous four fiscal years ending June 30th.
(i.e. – taxable wage base for 2006 = \$24, 00 per employee)

- **Reserve Factor:** A multiplier (factor), which is adjusted up or down on an annual basis depending on the overall health of the UI Trust Fund balance. That formula is based on maintaining a balance in the Trust Fund that can fund 17 to 19 months of benefits during a severe economic downturn. The Reserve Factor is set at 1.0 when the Trust Fund balance falls between the Maximum and Minimum Adequate Reserve levels. The Reserve Factor was reduced from 1.40 to 1.25 for 2006 tax rates.
- **Social Rate:** This rate is determined by benefit costs that cannot be charged to specific employers and is added to the UI tax rate for all employers; this is the minimum tax rate available. Over half of all Utah employers have the minimum rate in 2006 (.004). The social rate is calculated using “social costs” for the previous four fiscal years.

Background: State Representative Merlynn Newbold attended (via telephone) the December 1, 2005 Employment Advisory Council meeting. She inquired whether our Unemployment Insurance (UI) contribution statutes might be amended to provide some tax relief to an employer that had experienced a significant increase in its contribution rate in 2005. While the specifics of Representative Newbold’s constituent are unknown, a small number of employers may find themselves in a similar scenario as follows: An employer has UI benefit costs charged against its account, which subsequently triggers a large spike in the UI contribution rate the following year. The employer’s taxable payroll then increases dramatically in subsequent years. The employer may end up paying substantially more (up to 3-4 times more) in taxes over the next 3-4 years than the actual amount of benefit charges. The current tax formula was designed to increase an employer’s tax rate (over a four-year period) sufficiently to recover approximately the amount of benefits charged to the employer’s account, provided the employer’s payroll remains fairly similar in size in the year following the benefit charges.

Option One - limit the amount of an employer’s UI tax rate increase in any given year:

Utah, like all states, has a provision to cap the maximum rate but does not limit the size of a rate increase in any given year. Our research confirmed that such a provision would not be permitted under federal law. Utah would not be in conformity with Section 3303(a)(1) of the Federal Unemployment Tax Act (FUTA) if it were to adopt such a provision.

In 1984 the state of Minnesota passed a state UI law that limited an employer’s UI tax rate increase in any given year to a maximum of 2.5 percentage points and also had a provision to limit the increase to 1.5 percentage points for “small employers.” The Minnesota law was determined to be in nonconformity with FUTA and thus Minnesota repealed this provision from their law. Essentially Section 3303(a)(1) requires that any reduction in the rate of state UI taxes must be based on experience with respect to unemployment or other factors having a direct relation to the unemployment risk. The Minnesota provision could result in two employers with identical experience ratios (benefit charges/taxable wages) in the same year paying contributions at different rates, thus allowing one employer to pay a reduced rate based on a factor not related to unemployment risk. The size of a business is also not a factor bearing a relationship to unemployment risk.

Option Two – Voluntary Contributions to Buy down UI Benefit Costs: The only option, which appears viable, that would provide equal protection to all employers and still not have a significant negative impact on the UI Trust Fund is a provision known as a *Voluntary*

Contribution. The following is a brief description of the provision, the approximate number of employers that might be impacted, and the estimated costs involved in developing and administering such a provision.

Voluntary Contribution: The concept is fairly simple, it provides employers with the option (usually each year, when tax rates are calculated for the subsequent tax year) to buy back benefit costs that have been charged against their UI accounts, thereby reducing their benefit ratio (benefit costs / taxable wages) sufficiently to lower their future contribution rates for up to four years. Utah's unemployment experience rating system is referred to as a *benefit ratio formula*. There are 17 states using benefit ratio formulas; five (5) have provisions for voluntary contributions. The five (5) states are Michigan, Minnesota, Pennsylvania, Texas, and Washington. We talked with every state except Texas. All of these states allow for an employer to pay voluntary contributions to cancel benefit costs that have been charged to the employer's account.

Based on our review, Washington's law is one that should be closely examined if Utah should go forward with such a provision. Washington has provisions in place that limit the number of employers that would be eligible to participate in this option, it limits the costs involved in implementing and maintaining the provision, and somewhat limits the potential negative impact to the UI Trust Fund. The state of Washington has over 197,000 active contributory employers (approximately three times the number in Utah). Of these employers, an estimated 12,000 to 14,000 annually qualify for voluntary contribution participation. In the last two years only 13 to 14 employers exercised this option to voluntarily contribute to the Trust Fund to reduce their benefit charges; as many as 166 employers have exercised this option during the past 10 years. Most states require the payment within 30 days from the rate notice mailing. The state of Washington has the following provisions:

- Voluntary contributions restricted to the two most recently completed state fiscal years.
- Only those employers with significant rate changes are able to participate each year.
- Washington has 42 distinct rate classes; an employer's rate must have increased at least 12 rate classes from the previous year to qualify for participation.
- Washington employers are required to buy down a minimum of four rate classes.
- The state also assesses a 10 percent surcharge on the amounts contributed.

What might Utah's voluntary contribution program look like? Utah has about 62,000 active contributory employers. If Utah's provisions closely mirrored Washington's, and a similar percentage of Utah employers qualified to participate (7.1 percent), approximately 4,400 Utah employers might be eligible to participate annually. Approximately one tenth of one percent (0.1 percent) would exercise this option, which translates to four or five employers.

The following table shows the number of Utah employers whose rate increased from 2005 to 2006. For 2006, 14,521 employers had a rate increase. If we require a comparable percentage rate of increase to Washington's (a rate increase of a minimum of 3 percentage points), 2,715 Utah employers (4.4 percent) would qualify to participate in 2006. The table illustrates that the vast majority of rate increases are relatively small (1 percentage point or less).

2005-2006 Utah UI Rate Increases		
Class	Rate of Increase	# of Employers
1	.005 (.5%)	6,627
2	.010	2,422
3	.015	1,296
4	.020	890
5	.025	570
6	.030	504
7	.035	389
8	.040	279
9	.045	219
10	.050	194
11	.055	168
12	.060	133
13	.065	140
14	.070	115
15	.075	135
16	.080	133
17	.085	100
18	.090	206
Total		14,521

Estimated Costs to Implement and maintain: The Department estimates the total cost to implement this provision would be approximately \$486,000. Ongoing costs will vary each year depending on how many employers are eligible to participate and how many actually exercise the provision. We estimate the ongoing costs to be approximately \$5,000 to \$15,000 annually. It should be noted these cost estimates are **unfunded costs**. The Department would require additional funding or would be required to reduce UI program operations in other areas, most likely in UI compliance activities, which would almost certainly have a much larger negative impact on the Trust Fund than the cost of funding this provision. I recommend that if Utah adopts this provision that a 10 percent surcharge (like Washington's) be assessed and appropriated back to the Department. This would defray some portion of the ongoing costs to administer the provision.

Estimated impact on the UI Trust Fund: The actual impact on the Trust Fund can be calculated only after it has been in place for two or more years. It is difficult to forecast the impact, however, it is relatively safe to say that it would have some negative impact simply because an employer would not be likely to make a voluntary contribution unless the expected result in UI tax rate savings exceeded the amount contributed. We estimate that the potential costs to implement this provision will be greater than the tax benefit realized by the employers electing to participate in the year it is implemented. However, if the percentage of employers who elect to participate is similar to what other states have experienced, the provision should not have a significant impact.

Employer Business Option: Another option that employers might pursue if they felt their UI tax rates were excessively high would be to contract with a professional employer organization

(PEO) to *lease* their employees. The PEO would be responsible for the UI tax obligation and in most cases the benefit costs would not transfer to the PEO. The use of PEOs or temporary service employers is also a regularly used business method to mitigate the costs of temporary increases in employment needs. An employer can hire only the number of employees needed for an extended period of time, and use leased, temporary staff to make up the difference.

Summary: Should Utah pursue a voluntary contribution provision, we recommend the following guidelines:

- Create 18 distinct employer rate classes, grouped in increments of 0.5 percent (similar to the table above).
- Limit participation to employers that have experienced an annual rate class increase of at least four to six classes over the previous year.
- Limit the amount of benefit costs that may be bought back to the two (2) most recently completed state fiscal years.
- Apply voluntary contributions to the oldest benefit quarter first.
- Require that voluntary contributions be received within 30 days of the mailing of the annual rate notice.
- Require participating employers to be in good standing with the Department. The employer's (and predecessor's if applicable) past-due contributions, interest, penalties and costs must be paid in full, and all past-due reports must be filed within 30 days of the mailing of the annual rate notice.
- Assess a 10 percent surcharge (in addition to the voluntary contribution), which is appropriated back to the Department to defray any annual ongoing costs to administer the provision.
- Appropriate "Reed Act Funds" to cover "start-up" costs associated with implementation.

Other Thoughts to Consider: While the proposed provision may provide some relief to a small number of employers, it dilutes to some extent the basic tenants of our experience rating system. The UI experience rating system requires active participation by both claimants and employers to ensure that benefits are paid accurately and appropriately. The system provides incentives (via tax rates) to employers who stabilize or increase their employment without layoffs. The proposed provision somewhat erodes these incentives.